

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Wyland Analyst: Jeff Garnier Bill Number: AB 2328

Related Bills: See Prior Analysis Telephone: 845-5322 Amended Date: May 13, 2004

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: S Corporations/Built in Gains Tax /Conformity/ Accrual Method

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

☒ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended April 1, 2004.

_____ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED
APRIL 1, 2004 STILL APPLIES.

☒ OTHER - See comments below.

SUMMARY

This bill would provide limited tax relief for corporations required in 2002 to be "S" corporations for state purposes. In addition, this bill would conform to the current federal accrual method of accounting rules.

SUMMARY OF AMENDMENTS

The May 13, 2004 deleted all provisions of the bill except two. The provision relating to the federal "S" corporation election date would apply for California purposes to determine the built in gains tax on a "S" corporation, and conformity to the federal rules on the use of the accrual method of accounting also remain in the bill. These two sections of the April 1, 2004, bill analysis still apply. The remaining sections of the April 1, 2004, analysis no longer apply.

For convenience, what this bill does and the remaining policy concerns are repeated in this analysis. Please see the April 1, 2004, analysis for background information about "S" corporations and the accrual method of accounting. A new revenue discussion is also provided in this analysis.

POSITION

Pending.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	<input checked="" type="checkbox"/> PENDING

Legislative Director

Date

Brian Putler

6/16/04

THIS BILL

For "C" corporations required to be an "S" corporation for state purposes under the provisions of AB 1122, (Ch. 35, Sts. 2002) this bill would change, for purposes of determining the California Built In Gain (BIG) tax, the California "S" election date from the first day of the taxable year beginning in 2002 to the federal "S" election date. Because the provisions of AB 1122 apply to corporations that were federal "S" corporations prior to January of 2002, the federal election date will always be earlier than the first day the corporation became an "S" corporation for California. In the case of corporations that were federal "S" corporations prior to 1993, they will never be subject to the California BIG tax.

Under the Corporation Tax Law, this bill would conform state law to the Job Creation and Worker Assistance Act of 2002 federal law change with respect to the use of the accrual method of accounting. The federal law change further restricts the use of the cash method of accounting, thus requiring more taxpayers to use the accrual method of accounting.

ECONOMIC IMPACT

Revenue Estimate

Projected revenue losses are as follows (assumes enactment after 6/30/04):

Fiscal Year	2004-2005	2005-2006	2006-2007
Change of "S" Corporation Election Date Effect on the Built In Gain (BIG) Tax	Losses not exceeding \$1.5 million	Losses not exceeding \$500,000	Losses not exceeding \$500,000
Limitation of Non-Accrual Experience Method Accounting	Gains not exceeding \$4.5 million	Minor gains	Minor gains
TOTAL (order of magnitude)	\$3 million gain	Losses not exceeding \$500,000	Losses not exceeding \$500,000

Revenue Discussion

Effect on BIG tax - Since a corporation can postpone the sale of assets beyond the 10-year recognition period so as not to become subject to the built-in gains tax, it is not possible to determine the number of corporations that will become subject to the BIG tax as a result of the mandatory conversion to an "S" corporation. Currently only 0.3% of all "S" corporations report BIG tax with an average BIG tax liability of approximately \$26,000. This equates to approximately \$294,000 of built-in gains per corporation.

For purposes of this analysis, it is assumed that the BIG issue would affect approximately 1,300 "S" corporations. If 1% would be subject to the BIG tax annually over the next 10 years, this would impact less than 15 corporations each year. Assuming an average BIG tax of \$26,000 and average built-in gains of \$294,000, the elimination of the BIG tax would result in minor (under \$500,000)

revenue losses annually. The first fiscal year impacted by this bill (2004-05) includes three years of revenue losses.

Limitation on the use of non-accrual experience method of accounting -- The estimate for conformity to the federal limitation on use of the non-accrual experience method of accounting is based on federal projections for that provision. The 2004-05 impact for the state conformity includes the first two years of the federal projection since the provision would be effective for taxable years beginning on or after January 1, 2003.

POLICY CONCERNS

The bill would allow tax relief for some taxpayers and increase taxes for others for prior tax years. The bill fails to include a public purpose statement for retroactively reducing and increasing taxes.

The bill conforms to the federal treatment of the accrual method of accounting under the Corporation Tax Law, but neglects to conform under the Personal Income Tax Law. Thus, this bill would provide differing treatment based solely on classification, business type, or business organization.

LEGISLATIVE STAFF CONTACT

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